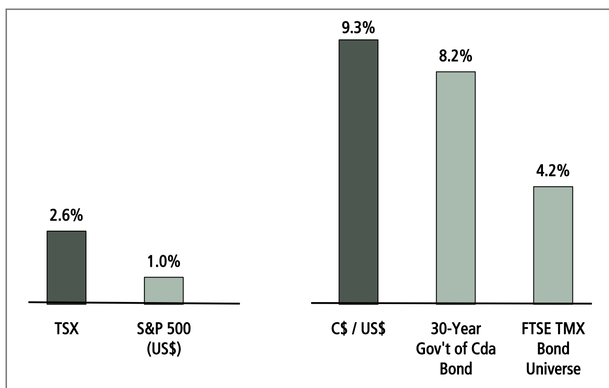
The Beat Goes On

In the first three months of 2015 returns on client portfolios were excellent. As an example, the Nexus Equity Fund was up 5.7% and the Balanced Fund was up 5.3%. In our last Nexus Report we predicted that the heady returns earned in 2014 were unlikely to persist. We were wrong, at least in the short term.

A closer inspection, however, reveals that a lot of the gain in portfolios came from surprising sources. The single best asset we owned was the U.S. dollar, which appreciated by 9.3% against the Canadian dollar in the quarter. While we certainly held some U.S. cash outright, most of the currency gain was realized in the U.S. stocks we owned. The major U.S. stock market index, the S&P 500, had a somewhat lackluster 1.0% total return in U.S. dollars; however, this translates into a whopping 10.3% when expressed in Canadian dollars. Similarly, a significant component of the returns from our foreign holdings came from currency appreciation against the Canadian dollar.

The other great asset class during the last three months was bonds. Just when we thought interest rates could not go any lower, they did. As a consequence, the return on the 30-year Government of Canada bond was 8.2% in the quarter, far outpacing most equity markets around the world (in local currencies). The broad bond market index, the FTSE TMX Universe, was up by 4.2%, a remarkably strong return as well.



Total Return for 3 Months Ended March 31, 2015

As we ponder these returns, one possible conclusion is that the steady global economic recovery we expected for 2015 may not be so certain any more. Fixed income markets are indicating that interest rates will remain low for a very long time, a condition most consistent with an extended period of weak economic growth. Similarly, many equity markets also reflect a growing uncertainty in the outlook for corporate earnings. While the S&P 500 in the U.S. finished the quarter nearly unchanged, daily volatility was intense. Nearly 30% of all trading days experienced index movements, up or down, of more than 1%.[1] This is not reflective of an investor base that is calm and confident in the future.

Déjà Vu

If Yogi Berra were describing economic conditions in the first quarter of 2015, he might invoke his famous phrase that "it's like déjà vu all over again". Last year at this time we tried to make sense of a string of surprisingly weak economic data, including an outright decline in U.S. GDP in the first three months of 2014. Our assessment at the time was that extreme winter weather through much of the Eastern U.S. was a prime culprit in causing a temporary disruption to what was otherwise a positive trend of economic recovery. This turned out to be correct and, through most of 2014, the U.S. economy acted as the principal engine of global economic growth.

Improbably, we confront almost precisely the same circumstances this year. Extreme winter weather plagued the U.S. Northeast for the second year in a row. At the same time, U.S. economic data also turned surprisingly weak in the first three months of 2015. A slump in consumer spending, capital investment and industrial production suddenly took the glow off what had been a "good news" story of an accelerating U.S. economic recovery. Perhaps the climax in this parade of disappointing news was the monthly U.S. payroll report for March, which showed that only 126,000 new jobs were created in the month relative to an expectation for 245,000. The reports for January and February also were revised lower. The official unemployment rate stayed steady at 5.5%, but only because the labour force participation rate[2] fell to 67.8%, the lowest level since 1978.

Despite the apparent similarities, we are not at all convinced that weather can explain the U.S. slowdown this year. Some observers point to other temporary factors such as an inventory correction and a short-term uptick in the savings rate as being catalysts for the U.S. slowdown. However, our concern is that the slowdown may be a little less

[1] Only 15% of trading days in 2014 experienced swings of more than 1% in either direction. *Barron's*, April 4, 2015.

[2] The participation rate is the percentage of the U.S. working-age population who are actively in the job market.

fleeting than it was in the first few months of 2014. The strong rise in the U.S. dollar may be finally taking its toll as U.S. companies struggle to remain internationally competitive. As well, despite the energy sector's relatively modest weight in the stock market indexes, it has a disproportionate effect on economic activity. As much as 40% of all U.S. capital investment is related to energy.[3] In the wake of the collapse in oil prices in the last year, this investment in energy is being slashed.

Our expectations for U.S. economic growth are not dire, but they are certainly more moderate than they were three months ago.

Concern for Canada

Late in March, Bank of Canada Governor Poloz warned that first quarter economic performance in Canada was likely to be "atrocious". His blunt terminology came as a surprise to investors more accustomed to vague or nuanced comments from central bankers. The reality is that the rapid decline in oil prices significantly affects the Canadian economy in two antithetical ways. On one hand, energy companies cut investment and lay off employees in order to cope with the changed circumstances. Businesses and consumers affected by this have less money to spend and energy-dependent provinces see a sharp drop in tax revenue. On the other hand, lower energy prices act like a tax cut for other consumers, and the accompanying decline in the Canadian dollar[4] makes industrial companies in central Canada much more competitive internationally. At the root of Poloz's comments, however, lies the fact that the negative impact of low oil prices manifests itself quickly, and the positive benefits take time to work through the system.

Two days after Governor Poloz's speech, Canadian GDP growth for January was released and it surprised investors by being "less bad" than expected. The Canadian economy contracted by 0.1% in January, less than was forecast by virtually every economist. The downturn was led by spending cuts in the energy sector, but also by heavy snow in Eastern Canada, which was a major drag on business activity. The upside came from stronger than expected goods production, including, ironically, higher than expected oil and gas production.[5]

Despite the modest positive surprise in Canadian economic performance in January, Governor Poloz's warning of atrocious economic performance in the first quarter of 2015 may yet prove to be accurate. Employment has stayed positive only because of hiring in the public sector. The private sector has shed an average of 9,000 jobs per month from December through February. Job losses from the closure of Target and Future Shop are still to come.

Nevertheless, we do believe that the decline in the price of oil is a two-sided story and expect to see the benefits work their way into the economy later in the year. We also think that current oil prices are at levels where very little of the world's oil production is economic. Prices will move higher in time, but we don't know when.

Perhaps as significant as the energy industry is to our outlook, is the pace of economic recovery in the U.S. Last quarter, our more optimistic outlook for Canada's growth was based largely on our belief that we would be pulled along by an accelerating U.S. economy. That no longer appears to be quite as certain as we thought. This, and the challenge of low energy prices, results in a more moderate outlook for Canada, but we do expect positive growth for the year as a whole.

Investment Outlook

As we look at stock markets in Canada and the U.S., we observe that valuations for many stocks are full. As well, because of the economic challenges described above, earnings expectations have been reduced. In the U.S., for example, S&P 500 earnings are expected to drop 4.6% in the first quarter as compared to the same period last year. This is the largest such decline since 2009. Interest rates have fallen further in 2015, to levels previously unimaginable. The 10-year Government of Canada bond now yields 1.36% and the 10-year U.S. Treasury note yields 1.92%.

The conclusion we draw from this, especially after the performance of client portfolios over the last three months, is that modest expectations are appropriate going forward. Valuations in both the Canadian and U.S. stock markets are high, but not extreme. Earnings may decline this quarter, but we expect modest growth to resume later in the year. Moreover, with interest rates as low as they are, there also is no real alternative to a long-term and patient approach to investing. By investing in high-quality companies with resilient businesses, good returns will accrue over time. We are as convinced of this today as much as ever.

[3] *Barron's*, March 28, 2015.

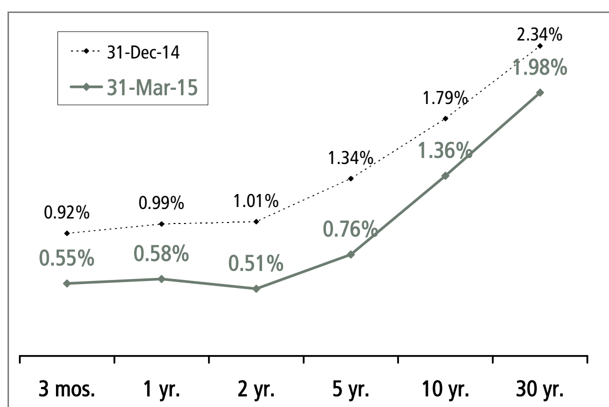
[4] The value of the Canadian dollar has been highly correlated with oil prices for many years.

[5] The increase in production came because a number of facilities that had been down for maintenance in the last quarter of 2014 came back online in the first quarter of 2015.

Asset Class Investment Review

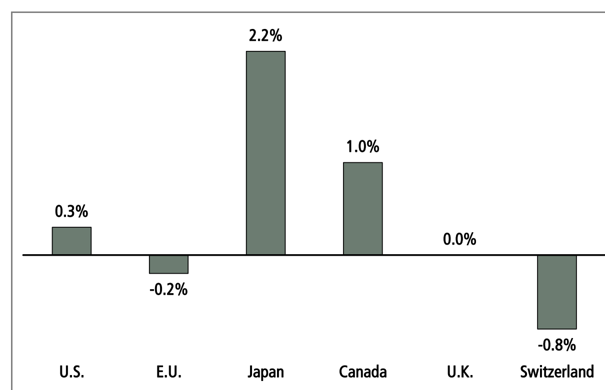
Fixed Income

In response to a surprise reduction in the Bank Rate from 1.00% to 0.75% in January, bond performance was strong again this quarter. Across the yield curve (pictured below) rates are at multi-generational lows. Ten-year Canada bonds ended the quarter at a yield of 1.36%, a drop of 43 basis points from the end of 2014. Yields on shorter term securities declined even more. Two-year yields declined 0.50%, from 1.01%to 0.51%. At these levels, future returns will be substantially below the targeted rate of inflation in this country. As a result of the sharp decline in rates, the FTSE TMX Bond Universe Index (the "Bond Index") generated a strong 4.2% return in the quarter. The return of our fixed income holdings, using those in the Income Fund as a proxy, was 3.8%. This return was perhaps more than most investors would have expected for the entire year.



Government of Canada Yield Curve

The rationale for low yields is the application of ultra-easy monetary policies in every major economy in the world. With the exception of the U.S., there is a concerted effort by central banks to stimulate investment and consumer spending with low rates, as well as to devalue their currencies to improve international competitiveness. Historically, such monetary largesse would have been fraught with the worry of rekindling inflation. But this is not now the case. Falling commodity prices and abundant slack in labour markets are pressuring inflation lower, as displayed in the graph in the next column. As well, structural changes to developed markets (primarily demographic) are slowing the natural rate of economic growth. As a result, economic slack is not being absorbed quickly and inflation is nowhere to be seen.



Annual Inflation Rates

In Canada, Bank of Canada Governor Poloz has been refreshingly candid in sharing the Bank's assessment of the state of Canada's economy. In both the official announcement in January of the reduction to the Bank Rate, as well as in other speeches, Bank staff cited low oil prices as both negative for growth and inflation.[6] What is essential to understand about this characterization is that, especially in Canada, the effects of the oil price shock are front-loaded in nature. Job losses and reduced investment spending in the energy sector are felt almost immediately. However, for much of the world, such as Japan, China and Europe, low energy prices are an economic stimulus. Eventually the positive effects arising from low energy prices – greater discretionary consumer spending (arising from lower gas and heating costs) and better corporate profitability (due to lower input costs) – will reveal themselves. However, those effects likely won't be felt until the second half of 2015. But eventually, global growth will accelerate and the current amount of monetary ease will become unnecessary.

As we consider the outlook for the balance of the year, it is hard to expect any better than flat returns from bond investments. But just as importantly, we don't foresee a sharp increase in yields either. Our portfolio remains concentrated in bonds of between 2 and 7 years in maturity (a duration of 4.6 years) and we retain a bias to higher-rated securities. It's a strategy designed to protect the gains of the last few years and be positioned to redeploy our investments when longer-term yields become more attractive.

[6] Bank of Canada Press Release of January 25, 2015.

Equities

The first quarter of 2015 was a good one for Nexus equity portfolios, with a substantial part of the return coming from currency gains. Non-Canadian equities were particularly strong, with each of our U.S., international developed markets, and emerging markets returns in the 9% to 15% range for the quarter.[7]

As an indicator of performance, the Equity Fund was up 5.7% in the first quarter and 19.1% for the past twelve months. The fund slightly lagged the benchmark in the quarter, but was was ahead by 2.7% for the twelve months.[8]

As we indicated last quarter, the torrid pace of equity market appreciation must surely slow down. We also reiterate that we don't think it is feasible to succesfully "time the markets" and we continue to believe that "time in the markets" with a quality equity portfolio will succeed over the long term. Of course, set-backs along the way are normal.

Canadian Equities

Nexus Canadian stocks were up 1.6% in the quarter and up 7.2% over the last twelve months. This was slightly behind the TSX Composite's 2.6% return for the quarter and slightly ahead of the TSX's 6.9% for the twelve months.

For the quarter and twelve months, Nexus Energy holdings have suffered badly after the big commodity sell-off. Mitigating this (as it relates to our overall equity portfolio return) was our relatively small weighting in the Canadian energy sector, no base or precious metals stocks and no U.S. energy holdings. At the other end of the spectrum, our strongest sectors in Canada for the quarter and twelve months have been our Consumer Staples, Consumer Discretionary and Industrials holdings. Of note amongst these are Alimentation Couche-Tard, Metro, Thomson Reuters, Brookfield Infrastructure Partners and Progressive Waste.

During the quarter, we established a new holding, Bombardier. Bombardier is a major Canadian manufacturer with two businesses – aircraft and railroad rollingstock – but one with awful shareholder returns. For several years, the company has been investing in three new aircraft platforms, with the principal one being the single-aisle 100 to 150 passenger C-Series. After costly delays to this program, the company finally brought in new management, narrowed its focus and raised new capital. We believe that improving prospects may at last lie ahead and Bombardier is cheap. Nonetheless, risks remain and Bombardier is atypical of our investment approach, so our holding is small and we will watch it closely.

U.S. Equities

After a good run, Nexus U.S. equities had a mediocre quarter measured in U.S. dollars. However, the stronger U.S. dollar was a big assist, so our U.S. equity portfolio was up 8.9% in in the first 3 months of the year. The twelve month return has been exceptionally strong, up 36.2%, and well ahead of the S&P 500 return of 29.4%.

An area of weakness during the quarter was some of our Technology holdings, especially Hewlett-Packard and Western Digital, but Microsoft was also impacted. These stocks are suffering from a slower PC-upgrade cycle relative to last year, a strong U.S. dollar, and poor emerging markets sales. With time, these effects will dissipate and we think the stocks are attractively valued, so we remain enthusiasts.

For the quarter and twelve months, our Consumer Staples, Consumer Discretionary and Healthcare holdings were positive stand-outs. Also contributing to our Healthcare performance were two stocks that we no longer own. We sold Sirona Dental in February. While we think it is a great company, it has become expensive even relative to its bright prospects. Also, as reported previously, we sold another successful holding, Covidien, in mid-2014 after it received a takeover offer from Medtronic.

Other Equity Investments

We continue to hold two non-North American equity investments within our Balanced and Equity Funds. These are two externally-managed pooled funds called EQIT (international developed market equities) and EMEC (international emerging market equities).[9]

Both EQIT and EMEC performed very well in the quarter (EQIT up 14.5% and EMEC up 11.6%). They were up 15.5% and 15.9%, respectively, over the twelve months. Both carry valuation multiples that are attractive compared to North-American equities.

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[7] Except where indicated, all U.S. and international returns are measured in Canadian dollars.

[8] All the return data in the Equities section is for the Equity Fund. Equity returns within the Balanced Fund were similar. For more specific performance, please refer to the Fund reports in this document or your client-specific report.

[9] Both funds are managed by teams from JPMorgan Asset Management based in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund had a very good start to 2015, advancing 5.7%. While strong on an outright basis, this result trailed our benchmark objective of 5.9%. Returns for longer periods continue to be excellent. The Fund returned 19.1% in the last 12 months, nicely ahead of the 16.4% return of our benchmark. More importantly, the Fund continues to provide attractive absolute and relative returns for longer holding periods. Over the last ten years, the Fund has generated an annual average return of 9.2%, well above the 7.9% return from the benchmark. More detail of the Fund's performance is laid out in the table below.

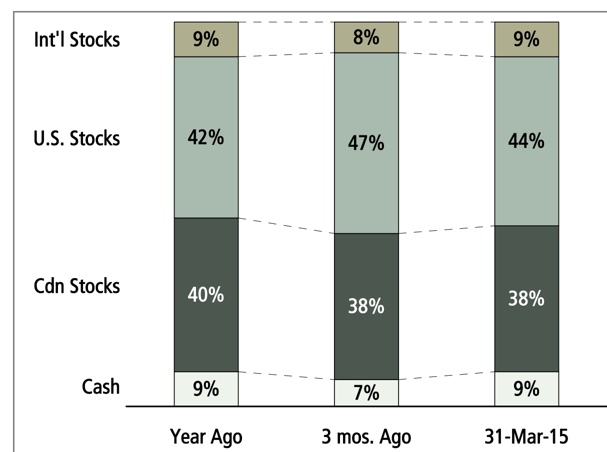
Although reported returns were good, much of the return owed to a sharp depreciation of the Canadian dollar. The Fund benefited from having a large weighting in U.S. stocks as well as exposure to international developed and emerging markets through our EQIT and EMEC holdings. Our U.S. and international holdings both provided much better returns in the last quarter and the last year than our Canadian equities did. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

Our cash position is 9%, slightly higher than it was at the end of the prior quarter and above our normal target of 5%. Given the strong run in markets, the sale of our holding of Sirona Dental and the accumulation of dividends, we have not been in a hurry to deploy this cash. In our judgment, it remains a time to emphasize quality and patience. Our allocation to Canadian stocks remains at 38%, about where it was when we last reported, and our U.S. allocation has decreased to 44% – largely as a result of the sale of Sirona. The balance of 9% is invested outside of North America through our holdings of EQIT and EMEC.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	5.7%	1.6%	8.9%	13.2%
Benchmark	*5.9%*	*2.6%*	*10.4%*	
One Year				
Fund	19.1%	7.2%	36.2%	15.6%
Benchmark	*16.4%*	*6.9%*	*29.4%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91-Day T-Bill, 50% TSX, and 45% S&P 500 (in C$) (rebalanced monthly); (b) for Cdn Stocks: TSX; and (c) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at March 31, 2015



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund had a strong start to 2015, advancing 5.3%. All asset classes provided positive returns and the Fund's return was ahead of its benchmark, which advanced 4.9% over the same period. The Fund has returned 15.7% in the last twelve months – exceeding the benchmark return of 13.0%, and our returns for 2, 3, 5 and 10 year periods also are higher than the benchmark and very attractive on an outright basis. More detail of the Fund's performance is laid out in the table below.

Beginning first with the bond market, despite the low level of interest rates, this remains an exciting time to be invested in bond markets. The quarter began with a well-telegraphed introduction of Quantitative Easing policies by the European Central Bank, a surprise interest rate cut from the Bank of Canada and then by a steady parade of new corporate and government bond issuance – much of it refinancing of higher cost capital or pre-borrowing of expected requirements at historically attractive rates. Although Canadian rates are at record low levels, by comparison with other countries they remain relatively appealing. As a result, foreign demand continues to be high. Returns for this portion of the Fund were 3.9%, but trailed the Bond Index return of 4.2%. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

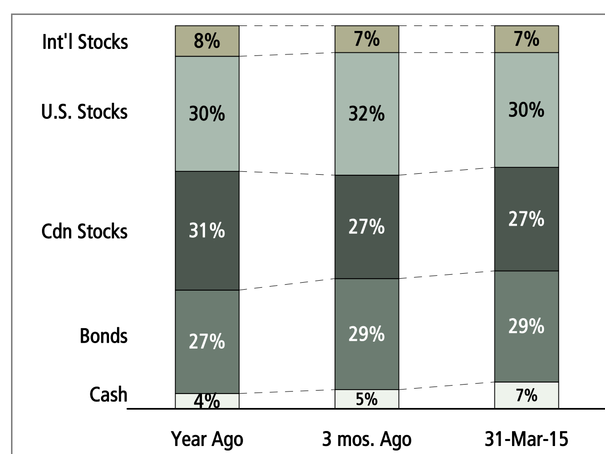
In equity markets, reported returns were good, but much of the return owed to a sharp depreciation of the Canadian dollar. The Fund benefitted from having a large weighting in U.S. stocks (31%), as well as exposure to international developed and emerging markets through our EQIT and EMEC holdings (7%). Both our U.S. and international holdings provided much better returns in both the last quarter and the last year than our Canadian equities did. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

Our overall asset mix was little changed from the prior quarter and the allocation between cash (7%), bonds (29%) and stocks (64%) remains very close to our long-term guidelines. Within equities, we continue to have more investments outside Canada, particularly in the U.S.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	5.3%	3.9%	1.2%	9.2%	10.1%
Benchmark	*4.9%*	*4.2%*	*2.6%*	*10.4%*	
One Year					
Fund	15.7%	8.3%	7.3%	35.0%	15.7%
Benchmark	*13.0%*	*10.3%*	*6.9%*	*29.4%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91-Day T-Bill, 30% FTSE TMX Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: FTSE TMX Universe Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at March 31, 2015



Balanced Fund Asset Mix

Nexus North American Income Fund

On an absolute return basis, the first quarter's return of 3.7% for the Nexus North American Income Fund continued the pattern of strong returns in 2014. However, this lagged the performance of the Fund's benchmark, the FTSE TMX Canada Universe Bond Index (the "Bond Index") which returned 4.2%. At the risk of stating the obvious, outsized returns from the bond market have arisen from the capital appreciation of bonds and not from high levels of interest earned. Our holdings, which have an average maturity shorter than the Bond Index, have done well, but have not had as much capital appreciation as the Bond Index. In the last 12 months, the Fund managed a return of 9.0%. More detail of the Fund's performance is laid out in the table below.

Despite the low level of interest rates, this remains an exciting time to be invested in bond markets. The quarter began with a well-telegraphed introduction of Quantitative Easing policies by the European Central Bank, a surprise interest rate cut from the Bank of Canada and then by a steady parade of new corporate and government bond issuance – much of it refinancing of higher cost capital or pre-borrowing of expected requirements at historically attractive rates. Although Canadian rates are at record low levels, by comparison with other countries they remain relatively appealing. As a result, foreign demand continues to be high. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

We continue to be pleased with the consistency of the returns and the low volatility of the Fund. We intend the Fund to be an excellent alternative to other savings products, and a superior alternative to traditional fixed income strategies. Returns continue to exceed inflation by a wide margin and, despite lagging slightly in the last 12 months, our long-term returns still comfortably exceed our benchmark over two, three, five and ten-year periods.

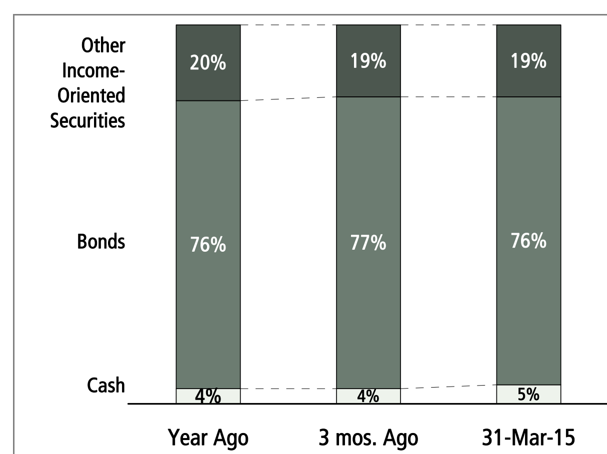
We have maintained our substantial allocation to 'Other Income-Oriented Securities' within the Fund. In the first quarter they provided a positive return but lagged the return of the Bond Index, our benchmark. Our 17 holdings are well diversified across 7 industrial sectors. As we emphasized last quarter, the attractiveness o these investments is two-fold: the ability of these companies to grow their dividends over time and the lower correlation of these securities with the Fund's core bond holdings. In fact, in periods of strong fixed income returns such as we've just experienced, it's actually expected that these investments might lag. But over time, the growth of dividends and the low correlation will help to create a pattern of higher returns with lower volatility than the Bond Index. In the quarter, five of our holdings increased their distributions.

Looking at asset mix, we remain almost fully invested in the 'Other Income-Oriented' sector, with an allocation of 19%, just slightly less than the level last quarter. Our core bond holdings represent 76% of the Fund and cash makes up the balance at 5%.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	3.7%	3.8%	3.2%	9.0%
Benchmark	*4.2%*	*4.2%*		
One Year				
Fund	9.0%	8.2%	13.0%	22.0%
Benchmark	*10.3%*	*10.3%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE TMX Universe Bond; (b) for Bonds: FTSE TMX Universe Bond.

Investment Returns – As at March 31, 2015



Income Fund Asset Mix

Financial Market Summary

Market Levels

	March 31, 2015	December 31, 2014
Canada		
TSX Composite Index	14,902	14,632
91-Day T-Bill Yield	0.91%	0.91%
30-Year Government of Canada Bond Yield	2.33%	2.33%
Prime Rate	3.00%	3.00%
Exchange Rate (US$ per C$)	0.7895	0.8620
United States		
Dow Jones Industrial Average	17,776	17,823
Standard & Poor's 500 Index	2,068	2,059
30-Year U.S. Treasury Yield	2.75%	2.75%

Market Returns for Periods Ended March 31, 2015 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
FTSE TMX 91-Day T-Bill Index	0.3%	0.9%	0.9%	1.9%
FTSE TMX Universe Bond Index	4.2%	10.3%	6.0%	5.6%
TSX Composite Index	2.6%	6.9%	7.4%	7.4%
S&P 500 Index (in C$)	10.4%	29.4%	19.7%	8.5%
MSCI EAFE Index (in C$)	14.7%	13.7%	11.0%	5.4%
MSCI Emerging Markets Index (in C$)	11.8%	15.2%	6.4%	9.0%

Notes:

[1] Market returns represent total returns, including income and capital appreciation (or depreciation).
[2] Market returns are compound annual rates for periods of more than 1 year, but are not annualized for shorter periods.